The Bursting Asset Bubbles

By: Sam Vaknin, Ph.D.

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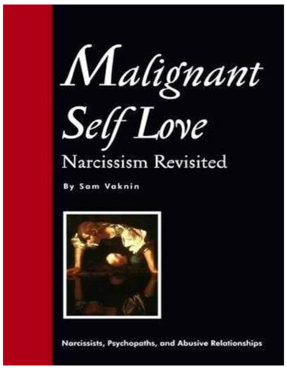

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I. Overview

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The recent implosion of the global equity markets - from Hong Kong to New York - engendered yet another round of the semipternal debate: should central banks contemplate abrupt adjustments in the prices of assets - such as stocks or real estate - as they do changes in the consumer price indices? Are asset bubbles indeed inflationary and their bursting deflationary?

Central bankers counter that it is hard to tell a bubble until it bursts and that market intervention bring about that which it is intended to prevent. There is insufficient historical data, they reprimand errant scholars who insist otherwise. This is disingenuous. Ponzi and pyramid schemes have been a fixture of Western civilization at least since the middle Renaissance.

Assets tend to accumulate in "asset stocks". Residences built in the 19th century still serve their purpose today. The quantity of new assets created at any given period is, inevitably, negligible compared to the stock of the same class of assets accumulated over decades and, sometimes, centuries. This is why the prices of assets are not anchored - they are only loosely connected to their production costs or even to their replacement value.

Asset bubbles are not the exclusive domain of stock exchanges and shares. "Real" assets include land and the property built on it, machinery, and other tangibles. "Financial" assets include anything that stores value and can serve as means of exchange - from cash to securities. Even tulip bulbs will do.

In 1634, in what later came to be known as "tulipmania", tulip bulbs were traded in a special marketplace in Amsterdam, the scene of a rabid speculative frenzy. Some rare black tulip bulbs changed hands for the price of a big mansion house. For four feverish years it seemed like the craze would last forever. But the bubble burst in 1637. In a matter of a few days, the price of tulip bulbs was slashed by 96%!

Uniquely, tulipmania was not an organized scam with an identifiable group of movers and shakers, which controlled and directed it. Nor has anyone made explicit promises to investors regarding guaranteed future profits. The hysteria was evenly distributed and fed on itself. Subsequent investment fiddles were different, though.

Modern dodges entangle a large number of victims. Their size and all-pervasiveness sometimes threaten the national economy and the very fabric of society and incur grave political and social costs.

There are two types of bubbles.

Asset bubbles of the first type are run or fanned by financial intermediaries such as banks or brokerage houses. They consist of "pumping" the price of an asset or an asset class. The assets concerned can be shares, currencies, other securities and financial instruments - or even savings accounts. To promise unearthly yields on one's savings is to artificially inflate the "price", or the "value" of one's savings account.

More than one fifth of the population of 1983 Israel were involved in a banking scandal of Albanian proportions. It was a classic pyramid scheme. All the banks, bar one, promised to gullible investors ever increasing returns on the banks' own publicly-traded shares.

These explicit and incredible promises were included in prospectuses of the banks' public offerings and won the implicit acquiescence and collaboration of successive Israeli governments. The banks used deposits, their capital, retained earnings and funds illegally borrowed through shady offshore subsidiaries to try to keep their impossible and unhealthy promises. Everyone knew what was going on and everyone was involved. It lasted 7 years. The prices of some shares increased by 1-2 percent daily.

On October 6, 1983, the entire banking sector of Israel crumbled. Faced with ominously mounting civil unrest, the government was forced to compensate shareholders. It offered them an elaborate share buyback plan over 9 years. The cost of this plan was pegged at $6 billion - almost 15 percent of Israel's annual GDP. The indirect damage remains unknown.

Avaricious and susceptible investors are lured into investment swindles by the promise of impossibly high profits or interest payments. The organizers use the money entrusted to them by new investors to pay off the old ones and thus establish a credible reputation. Charles Ponzi perpetrated many such schemes in 1919-1925 in Boston and later the Florida real estate market in the USA. Hence a "Ponzi scheme".

In Macedonia, a savings bank named TAT collapsed in 1997, erasing the economy of an entire major city, Bitola. After much wrangling and recriminations - many politicians seem to have benefited from the scam - the government, faced with elections in September, has recently decided, in defiance of IMF diktats, to offer meager compensation to the afflicted savers. TAT was only one of a few similar cases. Similar scandals took place in Russia and Bulgaria in the 1990's.

One third of the impoverished population of Albania was cast into destitution by the collapse of a series of nation-wide leveraged investment plans in 1997. Inept political and financial crisis management led Albania to the verge of disintegration and a civil war. Rioters invaded police stations and army barracks and expropriated hundreds of thousands of weapons.

Islam forbids its adherents to charge interest on money lent - as does Judaism. To circumvent this onerous decree, entrepreneurs and religious figures in Egypt and in Pakistan established "Islamic banks". These institutions pay no interest on deposits, nor do they demand interest from borrowers. Instead, depositors are made partners in the banks' - largely fictitious - profits. Clients are charged for - no less fictitious - losses. A few Islamic banks were in the habit of offering vertiginously high "profits". They went the way of other, less pious, pyramid schemes. They melted down and dragged economies and political establishments with them.

By definition, pyramid schemes are doomed to failure. The number of new "investors" - and the new money they make available to the pyramid's organizers - is limited. When the funds run out and the old investors can no longer be paid, panic ensues. In a classic "run on the bank", everyone attempts to draw his money simultaneously. Even healthy banks - a distant relative of pyramid schemes - cannot cope with such stampedes. Some of the money is invested long-term, or lent. Few financial institutions keep more than 10 percent of their deposits in liquid on-call reserves.

Studies repeatedly demonstrated that investors in pyramid schemes realize their dubious nature and stand forewarned by the collapse of other contemporaneous scams. But they are swayed by recurrent promises that they could draw their money at will ("liquidity") and, in the meantime, receive alluring returns on it ("capital gains", "interest payments", "profits").

People know that they are likelier to lose all or part of their money as time passes. But they convince themselves that they can outwit the organizers of the pyramid, that their withdrawals of profits or interest payments prior to the inevitable collapse will more than amply compensate them for the loss of their money. Many believe that they will succeed to accurately time the extraction of their original investment based on - mostly useless and superstitious - "warning signs".

While the speculative rash lasts, a host of pundits, analysts, and scholars aim to justify it. The "new economy" is exempt from "old rules and archaic modes of thinking". Productivity has surged and established a steeper, but sustainable, trend line. Information technology is as revolutionary as electricity. No, more than electricity. Stock valuations are reasonable. The Dow is on its way to 33,000. People want to believe these "objective, disinterested analyses" from "experts".

Investments by households are only one of the engines of this first kind of asset bubbles. A lot of the money that pours into pyramid schemes and stock exchange booms is laundered, the fruits of illicit pursuits. The laundering of tax-evaded money or the proceeds of criminal activities, mainly drugs, is effected through regular banking channels. The money changes ownership a few times to obscure its trail and the identities of the true owners.

Many offshore banks manage shady investment ploys. They maintain two sets of books. The "public" or "cooked" set is made available to the authorities - the tax administration, bank supervision, deposit insurance, law enforcement agencies, and securities and exchange commission. The true record is kept in the second, inaccessible, set of files.

This second set of accounts reflects reality: who deposited how much, when and subject to which conditions - and who borrowed what, when and subject to what terms. These arrangements are so stealthy and convoluted that sometimes even the shareholders of the bank lose track of its activities and misapprehend its real situation. Unscrupulous management and staff sometimes take advantage of the situation. Embezzlement, abuse of authority, mysterious trades, misuse of funds are more widespread than acknowledged.

The thunderous disintegration of the Bank for Credit and Commerce International (BCCI) in London in 1991 revealed that, for the better part of a decade, the executives and employees of this penumbral institution were busy stealing and misappropriating $10 billion. The Bank of England's supervision department failed to spot the rot on time. Depositors were - partially - compensated by the main shareholder of the bank, an Arab sheikh. The story repeated itself with Nick Leeson and his unauthorized disastrous trades which brought down the venerable and veteran Barings Bank in 1995.

The combination of black money, shoddy financial controls, shady bank accounts and shredded documents renders a true account of the cash flows and damages in such cases all but impossible. There is no telling what were the contributions of drug barons, American off-shore corporations, or European and Japanese tax-evaders - channeled precisely through such institutions - to the stratospheric rise in Wall-Street in the last few years.

But there is another - potentially the most pernicious - type of asset bubble. When financial institutions lend to the unworthy but the politically well-connected, to cronies, and family members of influential politicians - they often end up fostering a bubble. South Korean chaebols, Japanese keiretsu, as well as American conglomerates frequently used these cheap funds to prop up their stock or to invest in real estate, driving prices up in both markets artificially.

Moreover, despite decades of bitter experiences - from Mexico in 1982 to Asia in 1997 and Russia in 1998 - financial institutions still bow to fads and fashions. They act herd-like in conformity with "lending trends". They shift assets to garner the highest yields in the shortest possible period of time. In this respect, they are not very different from investors in pyramid investment schemes.

II. Case Study - The Savings and Loans Associations Bailout

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Asset bubbles - in the stock exchange, in the real estate or the commodity markets - invariably burst and often lead to banking crises. One such calamity struck the USA in 1986-1989. It is instructive to study the decisive reaction of the administration and Congress alike. They tackled both the ensuing liquidity crunch and the structural flaws exposed by the crisis with tenacity and skill. Compare this to the lackluster and hesitant tentativeness of the current lot. True, the crisis - the result of a speculative bubble - concerned the banking and real estate markets rather than the capital markets. But the similarities are there.

The savings and loans association, or the thrift, was a strange banking hybrid, very much akin to the building society in Britain. It was allowed to take in deposits but was really merely a mortgage bank. The Depository Institutions Deregulation and Monetary Control Act of 1980 forced S&L's to achieve interest parity with commercial banks, thus eliminating the interest ceiling on deposits which they enjoyed hitherto.

But it still allowed them only very limited entry into commercial and consumer lending and trust services. Thus, these institutions were heavily exposed to the vicissitudes of the residential real estate markets in their respective regions. Every normal cyclical slump in property values or regional economic shock - e.g., a plunge in commodity prices - affected them disproportionately.

Interest rate volatility created a mismatch between the assets of these associations and their liabilities. The negative spread between their cost of funds and the yield of their assets - eroded their operating margins. The 1982 Garn-St. Germain Depository Institutions Act encouraged thrifts to convert from mutual - i.e., depositor-owned - associations to stock companies, allowing them to tap the capital markets in order to enhance their faltering net worth.

But this was too little and too late. The S&L's were rendered unable to further support the price of real estate by rolling over old credits, refinancing residential equity, and underwriting development projects. Endemic corruption and mismanagement exacerbated the ruin. The bubble burst.

Hundreds of thousands of depositors scrambled to withdraw their funds and hundreds of savings and loans association (out of a total of more than 3,000) became insolvent instantly, unable to pay their depositors. They were besieged by angry - at times, violent - clients who lost their life savings.

The illiquidity spread like fire. As institutions closed their gates, one by one, they left in their wake major financial upheavals, wrecked businesses and homeowners, and devastated communities. At one point, the contagion threatened the stability of the entire banking system.

The Federal Savings and Loans Insurance Corporation (FSLIC) - which insured the deposits in the savings and loans associations - was no longer able to meet the claims and, effectively, went bankrupt. Though the obligations of the FSLIC were never guaranteed by the Treasury, it was widely perceived to be an arm of the federal government. The public was shocked. The crisis acquired a political dimension.

A hasty $300 billion bailout package was arranged to inject liquidity into the shriveling system through a special agency, the FHFB. The supervision of the banks was subtracted from the Federal Reserve. The role of the Federal Deposit Insurance Corporation (FDIC) was greatly expanded.

Prior to 1989, savings and loans were insured by the now-defunct FSLIC. The FDIC insured only banks. Congress had to eliminate FSLIC and place the insurance of thrifts under FDIC. The FDIC kept the Bank Insurance Fund (BIF) separate from the Savings Associations Insurance Fund (SAIF), to confine the ripple effect of the meltdown.

The FDIC is designed to be independent. Its money comes from premiums and earnings of the two insurance funds, not from Congressional appropriations. Its board of directors has full authority to run the agency. The board obeys the law, not political masters. The FDIC has a preemptive role. It regulates banks and savings and loans with the aim of avoiding insurance claims by depositors.

When an institution becomes unsound, the FDIC can either shore it up with loans or take it over. If it does the latter, it can run it and then sell it as a going concern, or close it, pay off the depositors and try to collect the loans. At times, the FDIC ends up owning collateral and trying to sell it.

Another outcome of the scandal was the Resolution Trust Corporation (RTC). Many savings and loans were treated as "special risk" and placed under the jurisdiction of the RTC until August 1992. The RTC operated and sold these institutions - or paid off the depositors and closed them. A new government corporation (Resolution Fund Corporation, RefCorp) issued federally guaranteed bailout bonds whose proceeds were used to finance the RTC until 1996.

The Office of Thrift Supervision (OTS) was also established in 1989 to replace the dismantled Federal Home Loan Board (FHLB) in supervising savings and loans. OTS is a unit within the Treasury Department, but law and custom make it practically an independent agency.

The Federal Housing Finance Board (FHFB) regulates the savings establishments for liquidity. It provides lines of credit from twelve regional Federal Home Loan Banks (FHLB).

Those banks and the thrifts make up the Federal Home Loan Bank System (FHLBS). FHFB gets its funds from the System and is independent of supervision by the executive branch.

Thus a clear, streamlined, and powerful regulatory mechanism was put in place. Banks and savings and loans abused the confusing overlaps in authority and regulation among numerous government agencies. Not one regulator possessed a full and truthful picture. Following the reforms, it all became clearer: insurance was the FDIC's job, the OTS provided supervision, and liquidity was monitored and imparted by the FHLB.

Healthy thrifts were coaxed and cajoled to purchase less sturdy ones. This weakened their balance sheets considerably and the government reneged on its promises to allow them to amortize the goodwill element of the purchase over 40 years. Still, there were 2,898 thrifts in 1989. Six years later, their number shrank to 1,612 and it stands now at less than 1,000. The consolidated institutions are bigger, stronger, and better capitalized.

Later on, Congress demanded that thrifts obtain a bank charter by 1998. This was not too onerous for most of them. At the height of the crisis the ratio of their combined equity to their combined assets was less than 1%. But in 1994 it reached almost 10% and remained there ever since.

This remarkable turnaround was the result of serendipity as much as careful planning. Interest rate spreads became highly positive. In a classic arbitrage, savings and loans paid low interest on deposits and invested the money in high yielding government and corporate bonds. The prolonged equity bull market allowed thrifts to float new stock at exorbitant prices.

As the juridical relics of the Great Depression - chiefly amongst them, the Glass-Steagall Act - were repealed, banks were liberated to enter new markets, offer new financial instruments, and spread throughout the USA. Product and geographical diversification led to enhanced financial health.

But the very fact that S&L's were poised to exploit these opportunities is a tribute to politicians and regulators alike - though except for setting the general tone of urgency and resolution, the relative absence of political intervention in the handling of the crisis is notable. It was managed by the autonomous, able, utterly professional, largely a-political Federal Reserve. The political class provided the professionals with the tools they needed to do the job. This mode of collaboration may well be the most important lesson of this crisis.

III. Case Study - Wall Street, October 1929

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Claud Cockburn, writing for the "Times of London" from New-York, described the irrational exuberance that gripped the nation just prior to the Great Depression. As Europe wallowed in post-war malaise, America seemed to have discovered a new economy, the secret of uninterrupted growth and prosperity, the fount of transforming technology:

"The atmosphere of the great boom was savagely exciting, but there were times when a person with my European background felt alarmingly lonely. He would have liked to believe, as these people believed, in the eternal upswing of the big bull market or else to meet just one

person with whom he might discuss some general doubts without being regarded as an imbecile or a person of deliberately evil intent - some kind of anarchist, perhaps."

The greatest analysts with the most impeccable credentials and track records failed to predict the forthcoming crash and the unprecedented economic depression that followed it. Irving Fisher, a preeminent economist, who, according to his biographer-son, Irving Norton Fisher, lost the equivalent of $140 million in today's money in the crash, made a series of soothing predictions. On October 22 he uttered these avuncular statements: "Quotations have not caught up with real values as yet ... (There is) no cause for a slump ... The market has not been inflated but merely readjusted..."

Even as the market convulsed on Black Thursday, October 24, 1929 and on Black Tuesday, October 29 - the New York Times wrote: "Rally at close cheers brokers, bankers optimistic".

In an editorial on October 26, it blasted rabid speculators and compliant analysts: "We shall hear considerably less in the future of those newly invented conceptions of finance which revised the principles of political economy with a view solely to fitting the stock market's vagaries." But it ended thus: "(The Federal Reserve has) insured the soundness of the business situation when the speculative markets went on the rocks."

Compare this to Alan Greenspan Congressional testimony this summer: "While bubbles that burst are scarcely benign, the consequences need not be catastrophic for the economy ... (The Depression was brought on by) ensuing failures of policy."

Investors, their equity leveraged with bank and broker loans, crowded into stocks of exciting "new technologies", such as the radio and mass electrification. The bull market - especially in issues of public utilities - was fueled by "mergers, new groupings, combinations and good earnings" and by corporate purchasing for "employee stock funds".

Cautionary voices - such as Paul Warburg, the influential banker, Roger Babson, the "Prophet of Loss" and Alexander Noyes, the eternal Cassandra from the New York Times - were derided. The number of brokerage accounts doubled between March 1927 and March 1929.

When the market corrected by 8 percent between March 18-27 - following a Fed induced credit crunch and a series of mysterious closed-door sessions of the Fed's board - bankers rushed in. The New York Times reported: "Responsible bankers agree that stocks should now be supported, having reached a level that makes them attractive." By August, the market was up 35 percent on its March lows. But it reached a peak on September 3 and it was downhill since then.

On October 19, five days before "Black Thursday", Business Week published this sanguine prognosis:

"Now, of course, the crucial weaknesses of such periods - price inflation, heavy inventories, over-extension of commercial credit - are totally absent. The security market seems to be suffering only an attack of stock indigestion... There is additional reassurance in the fact that, should business show any further signs of fatigue, the banking system is in a good position now to administer any needed credit tonic from its excellent Reserve supply."

The crash unfolded gradually. Black Thursday actually ended with an inspiring rally. Friday and Saturday - trading ceased only on Sundays - witnessed an upswing followed by mild profit taking. The market dropped 12.8 percent on Monday, with Winston Churchill watching from the visitors' gallery - incurring a loss of $10-14 billion.

The Wall Street Journal warned naive investors:

"Many are looking for technical corrective reactions from time to time, but do not expect these to disturb the upward trend for any prolonged period."

The market plummeted another 11.7 percent the next day - though trading ended with an impressive rally from the lows. October 31 was a good day with a "vigorous, buoyant rally from bell to bell". Even Rockefeller joined the myriad buyers. Shares soared. It seemed that the worst was over.

The New York Times was optimistic:

"It is thought that stocks will become stabilized at their actual worth levels, some higher and some lower than the present ones, and that the selling prices will be guided in the immediate future by the worth of each particular security, based on its dividend record, earnings ability and prospects. Little is heard in Wall Street these days about 'putting stocks up."

But it was not long before irate customers began blaming their stupendous losses on advice they received from their brokers. Alec Wilder, a songwriter in New York in 1929, interviewed by Stud Terkel in "Hard Times" four decades later, described this typical exchange with his money manager:

"I knew something was terribly wrong because I heard bellboys, everybody, talking about the stock market. About six weeks before the Wall Street Crash, I persuaded my mother in Rochester to let me talk to our family adviser. I wanted to sell stock which had been left me by my father. He got very sentimental: 'Oh your father wouldn't have liked you to do that.' He was so persuasive, I said O.K. I could have sold it for $160,000. Four years later, I sold it for $4,000."

Exhausted and numb from days of hectic trading and back office operations, the brokerage houses pressured the stock exchange to declare a two day trading holiday. Exchanges around North America followed suit.

At first, the Fed refused to reduce the discount rate. "(There) was no change in financial conditions which the board thought called for its action." - though it did inject liquidity into the money market by purchasing government bonds. Then, it partially succumbed and reduced the New York discount rate, which, curiously, was 1 percent above the other Fed districts - by 1 percent. This was too little and too late. The market never recovered after November 1. Despite further reductions in the discount rate to 4 percent, it shed a whopping 89 percent in nominal terms when it hit bottom three years later.

Everyone was duped. The rich were impoverished overnight. Small time margin traders - the forerunners of today's day traders - lost their shirts and much else besides. The New York Times:

"Yesterday's market crash was one which largely affected rich men, institutions, investment trusts and others who participate in the market on a broad and intelligent scale. It was not the margin traders who were caught in the rush to sell, but the rich men of the country who are able to swing blocks of 5,000, 10,000, up to 100,000 shares of high-priced stocks. They went overboard with no more consideration than the little trader who was swept out on the first day of the market's upheaval, whose prices, even at their lowest of last Thursday, now look high by comparison ... To most of those who have been in the market it is all the more awe-inspiring because their financial history is limited to bull markets."

Overseas - mainly European - selling was an important factor. Some conspiracy theorists, such as Webster Tarpley in his "British Financial Warfare", supported by contemporary reporting by the likes of "The Economist", went as far as writing:

"When this Wall Street Bubble had reached gargantuan proportions in the autumn of 1929, (Lord) Montagu Norman (governor of the Bank of England 1920-1944) sharply (upped) the British bank rate, repatriating British hot money, and pulling the rug out from under the Wall Street speculators, thus deliberately and consciously imploding the US markets. This caused a violent depression in the United States and some other countries, with the collapse of financial markets and the contraction of production and employment. In 1929, Norman engineered a collapse by puncturing the bubble."

The crash was, in large part, a reaction to a sharp reversal, starting in 1928, of the reflationary, "cheap money", policies of the Fed intended, as Adolph Miller of the Fed's Board of Governors told a Senate committee, "to bring down money rates, the call rate among them, because of the international importance the call rate had come to acquire. The purpose was to start an outflow of gold - to reverse the previous inflow of gold into this country (back to Britain)." But the Fed had already lost control of the speculative rush.

The crash of 1929 was not without its Enrons and World.com's. Clarence Hatry and his associates admitted to forging the accounts of their investment group to show a fake net worth of $24 million British pounds - rather than the true picture of 19 billion in liabilities. This led to forced liquidation of Wall Street positions by harried British financiers.

The collapse of Middle West Utilities, run by the energy tycoon, Samuel Insull, exposed a web of offshore holding companies whose only purpose was to hide losses and disguise leverage. The former president of NYSE, Richard Whitney was arrested for larceny.

Analysts and commentators thought of the stock exchange as decoupled from the real economy. Only one tenth of the population was invested - compared to 40 percent today. "The World" wrote, with more than a bit of Schadenfreude: "The country has not suffered a catastrophe ... The American people ... has been gambling largely with the surplus of its astonishing prosperity."

"The Daily News" concurred: "The sagging of the stocks has not destroyed a single factory, wiped out a single farm or city lot or real estate development, decreased the productive powers of a single workman or machine in the United States." In Louisville, the "Herald Post" commented sagely: "While Wall Street was getting rid of its weak holder to their own most drastic punishment, grain was stronger. That will go to the credit side of the national prosperity and help replace that buying power which some fear has been gravely impaired."

During the Coolidge presidency, according to the Encyclopedia Britannica, "stock dividends rose by 108 percent, corporate profits by 76 percent, and wages by 33 percent. In 1929, 4,455,100 passenger cars were sold by American factories, one for every 27 members of the population, a record that was not broken until 1950. Productivity was the key to America's economic growth. Because of improvements in technology, overall labour costs declined by nearly 10 percent, even though the wages of individual workers rose."

Jude Waninski adds in his tome "The Way the World Works" that "between 1921 and 1929, GNP grew to $103.1 billion from $69.6 billion. And because prices were falling, real output increased even faster." Tax rates were sharply reduced.

John Kenneth Galbraith noted these data in his seminal "The Great Crash":

"Between 1925 and 1929, the number of manufacturing establishments increased from 183,900 to 206,700; the value of their output rose from $60.8 billions to $68 billions. The Federal Reserve index of industrial production which had averaged only 67 in 1921 ... had risen to 110 by July 1928, and it reached 126 in June 1929 ... (but the American people) were also displaying an inordinate desire to get rich quickly with a minimum of physical effort."

Personal borrowing for consumption peaked in 1928 - though the administration, unlike today, maintained twin fiscal and current account surpluses and the USA was a large net creditor. Charles Kettering, head of the research division of General Motors described consumeritis thus, just days before the crash: "The key to economic prosperity is the organized creation of dissatisfaction."

Inequality skyrocketed. While output per man-hour shot up by 32 percent between 1923 and 1929, wages crept up only 8 percent. In 1929, the top 0.1 percent of the population earned as much as the bottom 42 percent. Business-friendly administrations reduced by 70 percent the exorbitant taxes paid by those with an income of more than $1 million. But in the summer of 1929, businesses reported sharp increases in inventories. It was the beginning of the end.

Were stocks overvalued prior to the crash? Did all stocks collapse indiscriminately? Not so. Even at the height of the panic, investors remained conscious of real values. On November 3, 1929 the shares of American Can, General Electric, Westinghouse and Anaconda Copper were still substantially higher than on March 3, 1928.

John Campbell and Robert Shiller, author of "Irrational Exuberance", calculated, in a joint paper titled "Valuation Ratios and the Lon-Run Market Outlook: An Update" posted on Yale University' s Web Site, that share prices divided by a moving average of 10 years worth of earnings reached 28 just prior to the crash. Contrast this with 45 on March 2000.

In an NBER working paper published December 2001 and tellingly titled "The Stock Market Crash of 1929 - Irving Fisher was Right", Ellen McGrattan and Edward Prescott boldly claim: "We find that the stock market in 1929 did not crash because the market was overvalued. In fact, the evidence strongly suggests that stocks were undervalued, even at their 1929 peak."

According to their detailed paper, stocks were trading at 19 times after-tax corporate earning at the peak in 1929, a fraction of today's valuations even after the recent correction. A March 1999 "Economic Letter" published by the Federal Reserve Bank of San-Francisco

wholeheartedly concurs. It notes that at the peak, prices stood at 30.5 times the dividend yield, only slightly above the long term average.

Contrast this with an article published in June 1990 issue of the "Journal of Economic History" by Robert Barsky and Bradford De Long and titled "Bull and Bear Markets in the Twentieth Century":

"Major bull and bear markets were driven by shifts in assessments of fundamentals: investors had little knowledge of crucial factors, in particular the long run dividend growth rate, and their changing expectations of average dividend growth plausibly lie behind the major swings of this century."

Jude Waninski attributes the crash to the disintegration of the pro-free-trade coalition in the Senate which later led to the notorious Smoot-Hawley Tariff Act of 1930. He traces all the important moves in the market between March 1929 and June 1930 to the intricate protectionist danse macabre in Congress.

This argument may never be decided. Is a similar crash on the cards? This cannot be ruled out. The 1990's resembled the 1920's in more than one way. Are we ready for a recurrence of 1929? About as we were prepared in 1928. Human nature - the prime mover behind market meltdowns - seemed not to have changed that much in these intervening seven decades.

Will a stock market crash, should it happen, be followed by another "Great Depression"? It depends which kind of crash. The short term puncturing of a temporary bubble - e.g., in 1962 and 1987 - is usually divorced from other economic fundamentals. But a major correction to a lasting bull market invariably leads to recession or worse.

As the economist Hernan Cortes Douglas reminds us in "The Collapse of Wall Street and the Lessons of History" published by the Friedberg Mercantile Group, this was the sequence in London in 1720 (the infamous "South Sea Bubble"), and in the USA in 1835-40 and 1929-32.

IV. Britain's Real Estate

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Updated April 2005

The five ghastly "Jack the Ripper" murders took place in an area less than a quarter square mile in size. Houses in this haunting and decrepit no man's land straddling the City and metropolitan London could be had for 25-50,000 British pounds as late as a decade ago. How things change!

The general buoyancy in real estate prices in the capital coupled with the adjacent Spitalfields urban renewal project have lifted prices. A house not 50 yards from the scene of the Ripper's last - and most ghoulish - slaying now sells for over 1 million pounds. In central London, one bedroom apartments retail for an outlandish half a million.

According to research published in September 2002 by Halifax, the UK's largest mortgage lender, the number of 1 million pound homes sold has doubled in 1999-2002 to 2600. By 2002, it has increased elevenfold since 1995. According to The Economist's house price index, prices rose by a further 15.6% in 2003, 10.2% in 2004 and a whopping 147% in total since 1997. In Greater London, one in every 90 homes fetches even a higher price. The average UK house now costs 100,000 pounds. In the USA, the ratios of house prices to rents and to median income are at historic highs.

One is reminded of the Japanese boast, at the height of their realty bubble, that the grounds of the royal palace in Tokyo are worth more than the entire real estate of Manhattan. Is Britain headed the same way?

A house - much like a Big Mac - is a basket of raw materials, goods, and services. But, unlike the Big Mac - and the purchasing power index it spawned - houses are also investment vehicles and stores of value. They yield often tax exempt capital gains, rental income, or benefits from occupying them (rent payments saved). Real estate is used to hedge against inflation, save for old age, and speculate. Prices of residential and commercial property reflect scarcity, investment fads, and changing moods.

Homeowners in both the UK and the USA - spurred on by aggressive marketing and the lowest interest rates in 30 years - have been refinancing old, more expensive, mortgages and heavily borrowing against their "equity" - i.e., against the meteoric rise in the market prices of their abodes.

According to the Milken Institute in Los Angeles, asset bubbles tend to both enhance and cannibalize each other. Profits from surging tradable securities are used to buy property and drive up its values. Borrowing against residential equity fuels overvaluations in fervid stock exchanges. When one bubble bursts - the other initially benefits from an influx of funds withdrawn in panic from the shriveling alternative.

Quantitatively, a considerably larger share of the nation's wealth is tied in real estate than in the capital markets. Yet, the infamous wealth effect - an alleged fluctuation in the will to consume as a result of changing fortunes in the stock exchange - is equally inconspicuous in the realty markets. It seems that consumption is correlated with lifelong projected earnings rather than with the state of one's savings and investments.

This is not the only counter-intuitive finding. Asset inflation - no matter how vertiginous - rarely spills into consumer prices. The recent bubbles in Japan and the USA, for instance, coincided with a protracted period of disinflation. The bursting of bubbles does have a deflationary effect, though.

In a late 2002 survey of global house price movements, "The Economist" concluded that real estate inflation is a global phenomenon. Though Britain far outpaces the United States and Italy (65% rise since 1997), it falls behind Ireland (179%) and South Africa (195%). It is in league with Australia (with 113%) and Spain (132%).

The paper notes wryly:

"Just as with equities in the late 1990s, property bulls are now coming up with bogus arguments for why rampant house-price inflation is sure to continue. Demographic change ... Physical restrictions and tough planning laws ... Similar arguments were heard in Japan in the late 1980s and Germany in the early 1990s - and yet in recent years house prices in these two countries have been falling. British house prices also tumbled in the late 1980s."

They are bound to do so again. In the long run, the rise in house prices cannot exceed the increase in disposable income. The effects of the bursting of a property bubble are invariably more pernicious and prolonged than the outcomes of a bear market in stocks. Real estate is much more leveraged. Debt levels can well exceed home equity ("negative equity") in a downturn. Nowadays, loans are not eroded by high inflation. Adjustable rate mortgages - one third of the annual total in the USA - will make sure that the burden of real indebtedness mushrooms as interest rates rise.

The Economist (April 2005):

"An IMF study on asset bubbles estimates that 40% of housing booms are followed by housing busts, which last for an average of four years and see an average decline of roughly 30% in home values. But given how many homebuyers in booming markets seem to be basing their purchasing decisions on expectations of outsized returns—a recent survey of buyers in Los Angeles indicated that they expected their homes to increase in value by a whopping 22% a year over the next decade—nasty downturns in at least some markets seem likely."

With both the equity and realty markets in gloom, people revert to cash and bonds and save more - leading to deflation or recession or both. Japan is a prime example of such a shift of investment preferences. When prices collapse sufficiently to become attractive, investors pile back into both the capital and real estate markets. This cycle is as old and as inevitable as human greed and fear.

Post Script

In 2007, a collapse in the subprime mortgage market in the United States precipitated a sharp global decline in housing starts and prices - as predicted. The year after, this led to a global credit crunch, the destabilization of the banking system, the demise of all the major investment banks in the USA, and recession throughout the industrialized world. The resultant drop in commodity and energy prices caused the slowdown to spread to developing countries as well.

IV. Notes on the Credit Crisis of 2007-9

The global crisis of 2007-9 was, actually, a confluence of unrelated problems on three continents. In the United States, investment banks were brought down by hyper-leveraged investments in ill-understood derivatives. As stock exchanges plummeted, the resulting devastation and wealth destruction spilled over into the real economy and caused a recession which is bound to be mild by historical standards.

Depending heavily on imported energy and exported goods, Europe's economy faced a marked slowdown as the region's single currency, the euro, appreciated strongly against all major currencies; as China, India, and other low-wage Asian countries became important exporters; as the price of energy products and oil skyrocketed; and as real estate bubbles burst in countries like Spain and Ireland. Additionally, European banks were heavily leveraged and indebted - far more than their counterparts across the Atlantic. Governments throughout the continent were forced to bail out one ailing institution after another, taxing further their limited counter-cyclical resources.

Simultaneously, in Asia, growth rates began to decelerate. Massive exposure to American debt, both public and private, served a vector of contagion. The weakening of traditional export markets affected adversely industries and employment. Stock exchanges tumbled.

The 2007-9 upheaval was so all-pervasive and so reminiscent of the beginnings of the Great Depression that it brought about a realignment and re-definition of the roles of the main economic actors: the state, the central banks, financial institutions of all stripes (both those regulated and in the "shadow banking" sector), the investment industries, and the various marketplaces (the stock exchanges, foremost).

1. Central Banks

The global credit crunch induced by the subprime mortgage crisis in the United States, in the second half of 2007, engendered a tectonic and paradigmatic shift in the way central banks perceive themselves and their role in the banking and financial systems.

On December 12, 2007, America's Federal Reserve, the Bank of England, the European Central Bank (ECB), the Bank of Canada and the Swiss National Bank, as well as Japan's and Sweden's central banks joined forces in a plan to ease the worldwide liquidity squeeze.

This collusion was a direct reaction to the fact that more conventional instruments have failed. Despite soaring spreads between the federal funds rate and the LIBOR (charged in interbank lending), banks barely touched money provided via the Fed's discount window. Repeated and steep cuts in interest rates and the establishment of reciprocal currency-swap lines fared no better.

The Fed then proceeded to establish a "Term Auction Facility (TAF)", doling out one-month loans to eligible banks. The Bank of England multiplied fivefold its regular term auctions for three months maturities. On December 18, the ECB lent 350 million euros to 390 banks at below market rates.

In March 2008, the Fed lent 29 billion USD to JP Morgan Chase to purchase the ailing broker-dealer Bear Stearns and hundreds of billions of dollars to investment banks through its discount window, hitherto reserved for commercial banks. The Fed agreed to accept as collateral securities tied to "prime" mortgages (by then in as much trouble as their subprime brethren).

The Fed doled the funds out through anonymous auctions, allowing borrowers to avoid the stigma attached to accepting money from a lender of last resort. Interest rates for most lines of credit, though, were set by the markets in (sometimes anonymous) auctions, rather than directly by the central banks, thus removing the central banks' ability to penalize financial institutions whose lax credit policies were, to use a mild understatement, negligent.

Moreover, central banks broadened their range of acceptable collateral to include prime mortgages and commercial paper. This shift completed their transformation from lenders of last resort. Central banks now became the equivalents of financial marketplaces, and akin to many retail banks. Fighting inflation - their erstwhile raison d'etre - has been relegated to the back burner in the face of looming risks of recession and protectionism. In September 2008, the Fed even borrowed money from the Treasury when its own resources were depleted.

As The Economist neatly summed it up (in an article titled "A dirty job, but Someone has to do it", dated December 13, 2007):

"(C)entral banks will now be more intricately involved in the unwinding of the credit mess. Since more banks have access to the liquidity auction, the central banks are implicitly subsidising weaker banks relative to stronger ones. By broadening the range of acceptable collateral, the central banks are taking more risks onto their balance sheets."

Regulatory upheaval is sure to follow. Investment banks are likely to be subjected to the same strictures, reserve requirements, and prohibitions that have applied to commercial banks since 1934. Supervisory agencies and functions will be consolidated and streamlined.

Ultimately, the state is the mother of all insurers, the master policy, the supreme underwriter. When markets fail, insurance firm recoil, and financial instruments disappoint - the government is called in to pick up the pieces, restore trust and order and, hopefully, retreat more gracefully than it was forced to enter.

The state would, therefore, do well to regulate all financial instruments: deposits, derivatives, contracts, loans, mortgages, and all other deeds that are exchanged or traded, whether publicly (in an exchange) or privately. Trading in a new financial instrument should be allowed only after it was submitted for review to the appropriate regulatory authority; a specific risk model was constructed; and reserve requirements were established and applied to all the players in the financial services industry, whether they are banks or other types of intermediaries.

2. Common Investment Schemes

The credit and banking crisis of 2007-9 has cast in doubt the three pillars of modern common investment schemes. Mutual funds (known in the UK as "unit trusts"), hedge funds, and closed-end funds all rely on three assumptions:

Assumption number one

That risk inherent in assets such as stocks can be "diversified away". If one divides one's capital and invests it in a variety of financial instruments, sectors, and markets, the overall risk of one's portfolio of investments is lower than the risk of any single asset in said portfolio.

Yet, in the last decade, markets all over the world have moved in tandem. These highly-correlated ups and downs gave the lie to the belief that they were in the process of "decoupling" and could, therefore, be expected to fluctuate independently of each other. What the crisis has revealed is that contagion transmission vectors and mechanisms have actually become more potent as barriers to flows of money and information have been lowered.

Assumption number two

That investment "experts" can and do have an advantage in picking "winner" stocks over laymen, let alone over random choices. Market timing coupled with access to information and analysis were supposed to guarantee the superior performance of professionals. Yet, they didn't.

Few investment funds beat the relevant stock indices on a regular, consistent basis. The yields on "random walk" and stochastic (random) investment portfolios often surpass managed funds. Index or tracking funds (funds who automatically invest in the stocks that compose a stock market index) are at the top of the table, leaving "stars", "seers", "sages", and "gurus" in the dust.

This manifest market efficiency is often attributed to the ubiquity of capital pricing models. But, the fact that everybody uses the same software does not necessarily mean that everyone would make the same stock picks. Moreover, the CAPM and similar models are now being challenged by the discovery and incorporation of information asymmetries into the math. Nowadays, not all fund managers are using the same mathematical models.

A better explanation for the inability of investment experts to beat the overall performance of the market would perhaps be information overload. Recent studies have shown that performance tends to deteriorate in the presence of too much information.

Additionally, the failure of gatekeepers - from rating agencies to regulators - to force firms to provide reliable data on their activities and assets led to the ascendance of insider information as the only credible substitute. But, insider or privileged information proved to be as misleading as publicly disclosed data. Finally, the market acted more on noise than on signal. As we all know, noise it perfectly randomized. Expertise and professionalism mean nothing in a totally random market.

Assumption number three

That risk can be either diversified away or parceled out and sold. This proved to be untenable, mainly because the very nature of risk is still ill-understood: the samples used in various mathematical models were biased as they relied on data pertaining only to the recent bull market, the longest in history.

Thus, in the process of securitization, "risk" was dissected, bundled and sold to third parties who were equally at a loss as to how best to evaluate it. Bewildered, participants and markets lost their much-vaunted ability to "discover" the correct prices of assets. Investors and banks got spooked by this apparent and unprecedented failure and stopped investing and lending. Illiquidity and panic ensued.

If investment funds cannot beat the market and cannot effectively get rid of portfolio risk, what do we need them for?

The short answer is: because it is far more convenient to get involved in the market through a fund than directly. Another reason: index and tracking funds are excellent ways to invest in a bull market.

3. Capital-Allocating Institutions

The main role of banks, well into the 1920, was to allocate capital to businesses (directly and through consumer credits and mortgages). Deposit-taking was a core function and the main source of funding. As far as depositors were concerned, banks guaranteed the safety and liquidity of the store of value (cash and cash-equivalents).

In the 1920, stock exchanges began to compete with banks by making available to firms other means of raising capital (IPOs - initial public offerings). This activity gradually became as important as the stock exchange's traditional competence: price discovery (effected through the structured interactions of willing buyers and sellers).

This territorial conflict led to an inevitable race to the bottom in terms of the quality of debtors and, ultimately, to the crash of 1929 and the Great Depression that ensued. Banks

then were reduced to retail activities, having lost their investment services to hybrids known as "investment banks".

The invention of junk bonds in the 1980s heralded a whole new era. A parallel, unregulated financial system has emerged which catered to the needs of businesses to raise risk capital and to the needs of those who provided such funds to rid themselves of the hazards inherent in their investments. Consumer credits and mortgages, for instance, were financed by traditional banking businesses. The risks associated with such lending were securitized and sold to third parties.

As expertise evolved and experience accumulated, financial operators learned to slice the hazards, evaluate them using value-at-risk mathematical models, tailor them to the needs of specific customer profiles, hedge them with complex derivatives, and trade them in unofficial, unregulated, though highly liquid amorphous, virtual "marketplaces".

Thus, stock exchanges have begun to lose their capital allocation functions to private equity funds, hedge funds, investment banks, and pension funds. In the process, such activities have become even more opaque and less regulated than before. This lack of transparency led to pervasive counterparty distrust and difficulties in price discovery. Ultimately, when the prices of underlying assets (such as housing) began to tumble, all liquidity drained and markets seized and froze.

Thus, at the end of 2006, the global financial system was comprised of three main groups of actors: traditional retail banks whose main role was deposit taking and doling out consumer credits; exchanges whose main functions were price discovery and the provision of liquidity; and investment banks and their surrogates and special purpose vehicles whose principal job was the allocation of capital to businesses and the mitigation of risk via securitization and insurance (hedging).

Yet, these unregulated investment banks were also often under-capitalized and hyper-leveraged partnerships (at least until the late 1990s, when some of them went public). This is precisely why they had invented all manner of complex financial instruments intended to remove credit-related risks from their books by selling it to third parties. Physicists, analysts, and rating agencies all agreed that the risk attendant to these derivatives can be calculated and determined and that many of them were risk-free (as long as markets were liquid, of course).

The business strategy of the investment banks was viable. It should have worked perfectly had they not committed a primal sin: they have entered the fray not only as brokers, dealers,

and mediators, but also as investors and gamblers (principals), taking on huge positions, often improperly hedged ("naked"). When these bets soured, the capital base of these institutions was wiped out, sometimes literally overnight. The very financial instruments that were meant to alleviate and reallocate risk (such as collateralized debt obligations - CDOs) have turned into hazardous substances, as investors (and investment banks) gambled on the direction of the economy, specific sectors, or firms.

In hindsight, the "shadow banks" subverted the very foundations of modern finance: they created money (modifying the money-printing monopoly of central banks); they obfuscated the process of price discovery and thus undermined the price signal (incidentally casting doubt on symmetrical asset pricing models); they interfered with the ability of cash and cash-equivalents to serve as value stores and thus shook the trust in the entire financial system; they amplified the negative consequences of unbridled speculation (that is not related to real-life economic activities and values); they leveraged the instant dissemination of information to render markets inefficient and unstable (a fact which requires a major revision of efficient market hypotheses).

This systemic dysfunctioning of financial markets led risk-averse investors to flee into safer havens: commodities, oil, metals, real estate and, finally, currencies and bonds. This was not merely a flight to quality: it was an attempt to avoid the abstract and fantastic "Alice in Wonderland" markets fostered by investment banks and to reconnect with tangible reality.

With the disappearance of investment banks (those who survived became bank holding companies), traditional banks are likely to regain some of their erstwhile functions: the allocation to businesses and creditworthy consumers and homeowners of deposit-based capital. The various exchanges will also survive, but will largely be confined to price discovery and the allocation of risk capital. Some financial instruments will flourish (credit-default swaps of all types), others will vanish (CDOs).

All in all, the financial scenery of 2010 will resemble 1910's more than it will 2005's. Back to basics and home-grown truths. At least until the next cataclysm.

V. The Crisis in Historical Context

Housing and financial crises often precede, or follow the disintegration of empires. The dissolution of the Habsburg and the British empires, as well as the implosion of the USSR were all marked by the eruption and then unwinding of imbalances in various asset, banking, and financial markets.

The collapse of Communism in Europe and Asia led to the emergence of a new middle class in these territories. Flushed with enhanced earnings and access to bank credits, its members unleashed a wave of unbridled consumption (mainly of imported goods); and with a rising mountain of savings, they scoured the globe for assets to invest their capital in: from football clubs to stocks and bonds.

The savings glut and the lopsided expansion of international trade led to severe asymmetries in capital flows and to the distortion of price signals. These, in turn, encouraged leveraged speculation and arbitrage and attempts to diversify away investment risks. The former resulted in extreme volatility and the latter in opaqueness and the breakdown of trust among market players and agents.

VI. The Next Crisis: Imploding Bond Markets

Written: November 3, 2008

To finance enormous bailout packages for the financial sector (and potentially the auto and mining industries) as well as fiscal stimulus plans, governments will have to issue trillions of US dollars in new bonds. Consequently, the prices of bonds are bound to come under pressure from the supply side.

But the demand side is likely to drive the next global financial crisis: the crash of the bond markets.

As the Fed takes US dollar interest rates below 1% (and with similar moves by the ECB, the Bank of England, and other central banks), buyers are likely to lose interest in government bonds and move to other high-quality, safe haven assets. Risk-aversion, mitigated by the evident thawing of the credit markets will cause investors to switch their portfolios from cash and cash-equivalents to more hazardous assets.

Moreover, as countries that hold trillions in government bonds (mainly US treasuries) begin to feel the pinch of the global crisis, they will be forced to liquidate their bondholdings in order to finance their needs.

In other words, bond prices are poised to crash precipitously. In the last 50 years, bond prices have collapsed by more than 35% at least on three occasions. This time around, though, such a turn of events will be nothing short of cataclysmic: more than ever, governments are relying on functional primary and secondary bond markets for their financing needs. There is no other way to raise the massive amounts of capital needed to salvage the global economy.

VII. Plus ca change ...

Two years later, many of the problems and imbalances that gave rise to the Great Recession are still with us and, owing to the might of special interest groups and Wall Street, are unlikely to be effectively tackled. This – coupled with the rampant mismanagement of public finances - virtually guarantee a second leg of this financial crisis in 2010.

Here is a partial list:

Synthetic collateralized debt obligations (structures of credit default swaps that yield streams of income identical to payments from pools of profile-specific mortgages) have not been banned or limited to the value of the underlying loans. Thus, leveraged, non-productive "wealth" is still being conjured out of thin air;

Naked short-selling and naked credit default swaps (writing or buying credit default swaps on securities not owned by the seller or buyer) are still allowed;

Brokerage firms and investment banks are still permitted to bet against securities held in their clients' portfolios (often placed there by the very same "financial experts" and "investment advisors");

Profits in the financial system are still siphoned off into huge bonus pools rather than augment balance sheets, capital ratios, and repay the bailout money forked out by taxpayers;

Bank deposits insured by the FDIC are still intermingled with and used in derivatives trading and investments in risky assets, such as equities and corporate bonds;

Accounting rules still allow the booking of profits on hedged investments, regardless of counterparty risk (frequently the result of wrong-way risk: when the insurer is as likely to be as damaged by the insurance event as the investor) and systemic or liquidity hazards (market failures);

Compensation in the financial sector is still divorced from long-term performance. This creates moral hazard and agent-principal conflicts.

Interview granted to Bankrate.com, August 2010

Q. Why would deflation happen in the United States?

A. For deflation to happen in the USA, an unlikely confluence of economic developments and policy errors must occur. Unemployment must resurge and reach levels of well above 15% on a prolonged and sustained basis; consumption and, consequently, capital investment must collapse; asset prices – especially equity and residential real-estate – must crumble; the banking system must suffer a substantial contraction; the government must cut its budget deficit considerably and abruptly; and the Federal Reserve must turn strict and demonetize the economy (bleed it dry by siphoning off liquidity). None of these six doomsday scenarios is likely to materialize.

The USA is probably facing years of low inflation, which has pernicious effects of its own, but is not the same as deflation.

Q. How would deflation affect investment and consumption? I have trouble wrapping my head around the concept that inflated dollars are worth more and deflated dollars are worth less, for some reason.

A. It is the other way around, according to orthodox monetary economics: inflated dollars are worth less and deflated dollars are worth more. Deflation means that the prices of goods and services are going down and so the purchasing power of your dollars is going up. Traditional economics claims that deflation actually increases the value of cash to its holder by enhancing its purchasing power in an environment of declining prices (negative growth in the average price level). Consumers are thus incentivized to delay their consumption. If prices are going down, why not wait and purchase the same for less later on?

In my view, though, this is only true in the short-term. It is true that in a deflationary cycle, consumers are likely to delay consumption in order to enjoy lower prices later. But this paralysis in consumption is precisely what renders most asset classes – including cash – precarious and unprofitable in the long-term.

On the policy level, deflationary expectations (let alone actual deflation) lead to "liquidity traps": zero interest-rates fail to stimulate the economy and the monetary authorities – unable to reduce interest rates further - remain powerless with their ammunition depleted. This means that cash balances and fixed-term deposits in banks yield no interest. But, even zero

interest translates into a positive yield in conditions of deflation. Theoretically, this fact should be enough to drive most people to hold cash.

Yet, what economists tend to overlook is transaction costs: banks charge account fees that outweigh the benefits of possessing cash even when prices are decreasing. Only in extreme deflation is cash with zero interest a profitable proposition when we take transaction costs (bank fees and charges) into account. But extreme deflation usually results in the collapse of the banking system as deleveraging and defaults set in. Cash balances and deposits evaporate together with the financial institutions that offer them.

Moreover: deflation results in gross imbalances in the economy: delayed consumption and capital investment and an increasing debt burden (in real, deflation-adjusted terms) adversely affect manufacturing, services, and employment. Government finances worsen as unemployment rises and business bankruptcies soar. Sovereign debt (government bonds) – another form of highly-liquid, "safe" investment – is thus rendered more default-prone in times of deflation.

Like inflation, deflation is a breakdown in the consensus over prices and their signals. As these are embodied in the currency and in other forms of debt, a prudent investor would stay away from them during periods of economic uncertainty. At the end, and contrary to the dicta of current economic orthodoxy, both deflation and inflation erode purchasing power. Thus, all asset classes suffer: equity, bonds, metals, currencies, even real-estate. The sole exception is agricultural land. Food is the preferred means of exchange in barter economies which are the tragic outcomes of the breakdown in the invisible hand of the market.

Q. What can consumers do to protect themselves from deflation and inflation, on an investment level as well as in the broader economy?

A. Inflation increases the state's revenues while eroding the real value of its debts, obligations, and expenditures denominated in local currency. Inflation acts as a tax and is fiscally corrective, but without the recessionary and deflationary effects of a "real" tax. Thus, inflation is bad for government bonds and deflation increases their value (lowers their yields). Inflation-linked bonds, though, are a great investment at all times, even with minimal deflation.

Inflation also improves the lot of corporate - and individual - borrowers by increasing their earnings and marginally eroding the value of their debts (and savings). It constitutes a disincentive to save and an incentive to borrow, to consume, and, alas, to speculate. "The Economist" called it "a splendid way to transfer wealth from savers to borrowers." So, inflation is good for equity markets in the short to medium term, while deflation has exactly the opposite effect.

The connection between inflation and asset bubbles is unclear. On the one hand, some of the greatest fizz in history occurred during periods of disinflation. One is reminded of the global boom in technology shares and real estate in the 1990's. On the other hand, soaring inflation forces people to resort to hedges such as gold and realty, inflating their prices in the process. Inflation - coupled with low or negative interest rates - also tends to exacerbate perilous imbalances by encouraging excess borrowing, for instance.

Deflation is kind to cash and cash-equivalents (e.g., fixed-term deposits and CDs), but only in the short-term. In the long-term it has an adverse effect on all asset classes (see what happened in Japan in the 1990s) with the exception of agricultural land.

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Write to me: palma@unet.com.mk or narcissisticabuse-owner@yahoogroups.com